MORTGAGE MARKET TRENDS

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REGULATORY AND LEGISLATIVE CHANGES IN THE MORTGAGE MARKET

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INTRODUCTION•

In past issues of *Mortgage Market Trends*, we have focused on market developments that might affect the credit-related performance of the mortgage portfolios held by thrifts. In this issue, we focus on a different aspect of the mortgage market: how current regulatory and legislative developments might affect the way thrifts conduct their mortgage business in the future. We will look at three recent developments, high loan-to-value mortgages and OTS's concerns, an expansion and changes in FHA lending programs, and the Chicago Federal Home Loan Bank's *Mortgage Finance Plan*Ò (MPFÒ). Each of these may well change the way thrifts lend in the future.

First, though, we look at current mortgage market conditions.

CURRENT MORTGAGE MARKET CONDITIONS

National Delinquency Rates Remain Low

Figure 1 plots the percentage of seriously delinquent (90 days past-due or in foreclosure) residential mortgages, using both the Mortgage Information Corporation (MIC) and Thrift Financial Report (TFR) data. The MIC data comprise almost 24 million mortgages. Since the first issue of the *Mortgage Market Trends*, we have divided the MIC data into two groups: the market, which includes all MIC participants (Freddie Mac, Fannie Mae, and eighteen other large banks, thrifts, and private mortgage lenders), and a subgroup, depository institutions, which includes only the FDIC-insured MIC participants (a mix of S&Ls and commercial banks). As the trend line in Figure 1 shows, the national delinquency rate improved in the last quarter. Both the MIC depository and OTS-regulated (TFR) thrift delinquency rates improved as well.

Figure 1 also shows that depositories, as a group, have had a higher delinquency rate than the national average for the entire period. The gap between the depository and the market delinquency rates has remained fairly constant since June 1997. The thrift industry, though, has improved its performance so much over the last few quarters that its delinquency rate has dropped **below** the MIC national rate (which is dominated by the GSEs' portfolio of conforming mortgages) for the last three consecutive quarters .

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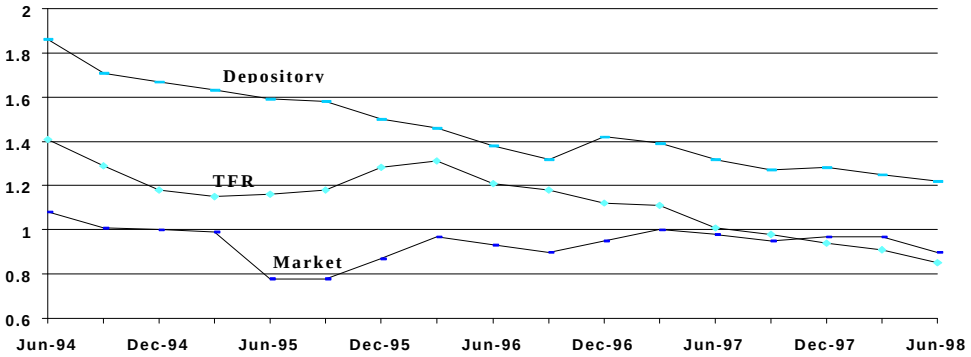
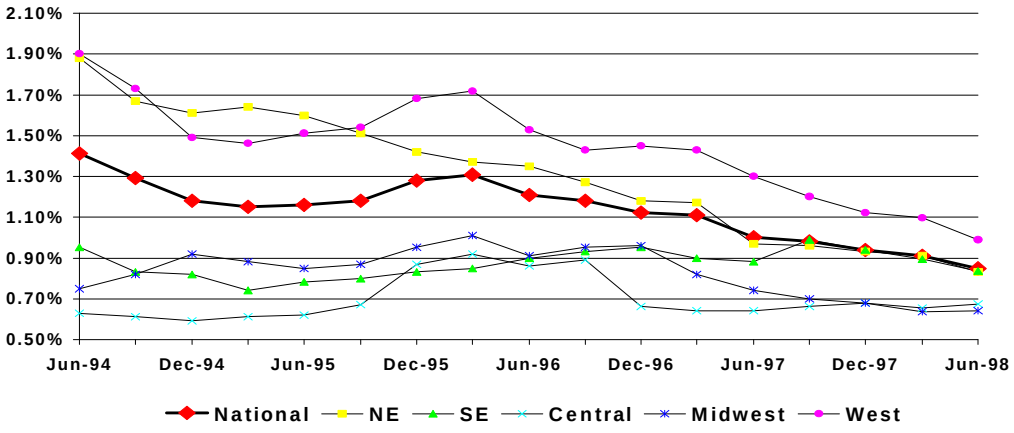
Figure 1: Percentage of Seriously Delinquent Mortgages



Source: MIC and TFR. The *Market* contains the combined data of the depository and non-depository participants in MIC's Loan Performance System. *Depositories* comprise both bank and thrift MIC participants. The thrift MIC participants are very large institutions located primarily on the East and West coasts. *TFR* represents all OTS-regulated institutions except one that specializes in defaulted mortgages.

Figure 2 shows the regional detail behind the improvement of the overall thrift delinquency rate. The West region experienced the greatest improvement, with the Northeast and Southeast regions also registering significant declines. The Central and Midwest regions maintained the lowest delinquency rates among the regions. For the first time since we have been tracking these data, all regions reported a seriously delinquent rate below 1%.

Figure 2: OTS Regional Delinquency Rates



Serious Delinquencies Vary by Location and Product Type

In June 1998, the states with the highest rates of seriously delinquent loans (by dollar value) were Maryland (1.68%), Hawaii (1.57%), New Jersey (1.50%), District of Columbia (1.49%), and New York (1.49%). The national average was 0.90%. California's rate improved from 1.16% in March to 1.04% in June.

In individual markets, Riverside, CA, leads the nation with a seriously delinquent rate of 2.65%, followed by Memphis, TN (2.32%), and Scranton, PA (2.08%). Among major markets, Miami (1.70%), New York (1.52%), and Los Angeles (1.50%) are in the top ten in terms of delinquency rates.

Table 1 shows the percentage of mortgages that are seriously delinquent for different product types (conventional and government-backed, fixed rate and adjustable) based on whether the mortgages were made for purchase or for refinancing. These data show that fixed rate mortgages outperform adjustable rate mortgages; 15 year fixed rate mortgages outperform 30 year mortgages. Refinanced mortgages perform much better than home purchase mortgages in all cases except one. The one exception is COFI ARMs, where the refinanced mortgages have a slightly higher delinquency rate than COFI ARM home purchase loans. The data also show that delinquency rates on government-backed loans substantially exceed those on conventional loans. This issue will be explored in more detail later in this report.

Table 1: Percent Seriously Delinquent, as of 6/98

	Home Purchase	Refinancing
Conv: Fixed Rate	0.61	0.27
15-Yr Fixed	0.42	0.10
30-Yr Fixed	0.64	0.37
Conv: Adj Rate	1.05	0.92
T-Bill	0.95	0.78
COFI	1.17	1.29
Government	3.40	2.07
FHA	3.63	1.90
VA	3.00	2.30
All Loans	1.06	0.43

Source: MIC, based on $ amounts

Market Share Data

Table 2 reports data on mortgage loan originations from HUD's *Survey of Mortgage Lending Activity (SMLA)*. The fourth quarter 1997 data are the most recent available. In the fourth quarter of 1997, the thrift industry's (Savings Banks and Savings Associations) market share of single-family residential mortgages fell from 17.9% to 15.6%, its lowest level ever. Commercial banks also declined in market share, falling from 23.7% in the third quarter to 19.7% in the fourth quarter. The market share for mortgage companies rose to 64.2% in the fourth quarter, the highest level ever.

Table 2: Mortgage Market Shares
($ in millions)

Year	CB	Share	SB	Share	S&L	Share	MC	Share	Total
1996 Q1	$43166	22.2%	$6766	3.5%	$28394	14.6%	$114557	59.0%	$194196
Q2	45927	22.0%	9120	4.4%	35064	16.8%	117583	56.2%	209140
Q3	42327	22.2%	9979	5.2%	30362	15.9%	106637	55.9%	190722
Q4	47128	24.6%	8036	4.2%	27895	14.6%	106962	55.9%	191271
1997 Q1	48116	28.0%	5651	3.3%	25015	14.6%	91819	53.5%	171787
Q2	53150	26.8%	6286	3.2%	34411	17.3%	103294	52.0%	196910
Q3	52667	23.7%	5210	2.3%	34518	15.6%	128126	57.7%	221888
Q4	52648	19.7%	4680	1.8%	36893	13.8%	171371	64.2%	266910

Source: *Survey of Mortgage Lending Activity*, HUD
CB, Commercial Banks; SB, Savings Banks; S&L, OTS thrifts; MC, Mortgage Companies

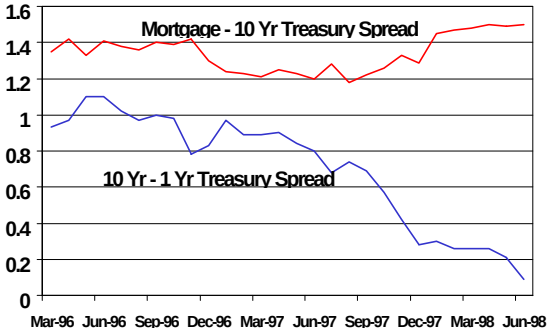
Interest Rate Changes

As evidenced by the narrowing spread between the ten-year constant maturity Treasury (CMT) rate and the one-year CMT pictured in Figure 3, the yield curve flattened sharply over the first six months of 1998. In June, the ten-year constant maturity Treasury rate stood at 5.5%, barely higher than the one-year CMT rate of 5.41%. This flat yield curve favors fixed rate over adjustable rate mortgages.

Figure 3 also shows the spread between the Federal Home Loan Mortgage Corporation's thirty day commitment rate for thirty-year mortgages and the ten-year CMT. The two rates are of similar duration and often track each other closely. Of note is the rise in the spread since June of last year. Although mortgage rates have fallen (the FHLMC commitment rate was 7% in June vs.7.69% a year ago), the rate is now higher, relative to the ten-year CMT, than it was a year ago.

At least three explanations have been offered for the recent increase in the mortgage commitment rate and the ten-year CMT spread. First, the demand for Treasury instruments is exceptionally strong given the current turmoil in international markets. Second, the supply of new Treasury bonds has been lowered due to the federal budget surplus, the first in almost 30 years. Both of these changes will increase the price of Treasury bonds and correspondingly decrease Treasury interest rates. Third, prepayment speeds on mortgages have been increasing during the current refinancing boom and this additional risk may be reflected in a higher mortgage commitment rate. All three reasons appear to help explain the larger spread. How long the current, increased spread will remain will depend on the duration of these current trends.

Figure 3: Yield Spreads



Originations by Product and LTV

The Federal Housing Finance Board conducts its *Mortgage Interest Rate Survey* (*MIRS*) monthly among mortgage lenders on the interest rates and terms of their recently closed conventional (non-government-backed) mortgages. Table 3 reports the survey results for the months ending each quarter over the last eighteen months.

Table 3 shows that, for all three lender groups, mortgage effective interest rates (which include the amortization of initial fees and charges over a ten-year period) have declined sharply since the end of June 1997. For S&Ls, the current average is 6.90%, for commercial banks, 7.21%, and for mortgage companies, 7.29%. The average effective interest rate was substantially lower for S&Ls than that for the commercial banks and mortgage companies in every quarter surveyed.

Table 3: Mortgage Rates and Terms
(Conventional Home Purchase Mortgages)

	Effective Rate	Percent of Loans by LTV Class				% Arms
		< 70%	70-80	80-90	>90	
S&Ls						
Mar-97	7.34	21	47	16	16	46
Jun-97	7.33	22	45	16	17	56
Sep-97	7.12	21	49	15	15	53
Dec-97	7.05	25	48	13	14	45
Mar-98	6.96	24	46	14	16	36
Jun-98	6.90	25	47	13	15	39
Commercial Banks						
Mar-97	7.77	20	39	19	22	31
Jun-97	7.86	21	38	18	22	21
Sep-97	7.59	22	37	17	24	16
Dec-97	7.46	18	32	16	35	9
Mar-98	7.22	15	34	16	36	9
Jun-98	7.21	15	31	14	40	9
Mortgage Companies						
Mar-97	7.92	19	34	17	30	14
Jun-97	8.03	18	36	17	28	16
Sep-97	7.77	19	36	18	27	13
Dec-97	7.51	19	36	17	27	8
Mar-98	7.28	20	37	17	27	6
Jun-98	7.29	19	37	16	28	7

Source: Mortgage Interest Rate Survey, Federal Housing Finance Board

The flat yield curve over the last three quarters continues to affect ARM originations. S&Ls have traditionally originated a higher proportion of ARMs than either commercial banks or mortgage banks, and this pattern persists. While more than half of S&L's originations are typically ARMs, for the first half of this year, the percentage had fallen below 40%. At commercial banks and mortgage companies, the decline in ARM originations has been even more dramatic. Only 9% of the commercial banks' and 7% of the mortgage companies' originations were ARMs during the second quarter of 1998.

The distribution of originations by loan-to-value ratios can also create differences in the effective interest rates between S&Ls and commercial banks and mortgage companies. Over the last year and a half, S&Ls have traditionally originated a much smaller percentage of their loans in the highest LTV category (greater than 90% LTV ratio) than the other two originators, and this continues. This difference between commercial banks and S&Ls should eventually be reflected in the respective charge-off rates, as high LTV loans are riskier than low LTV loans. Because of their higher credit risk, higher LTV-ratio loans should carry a higher rate and/or more fees and charges than lower LTV-ratio loans. This explains, in part, the difference in effective mortgage rates between S&Ls and commercial banks.

CURRENT MARKET AND REGULATORY DEVELOPMENTS

FHA Developments

In October 1998, the Department of Housing and Urban Development (HUD) announced changes, approved by Congress, for the FHA mortgage loan program. These changes are designed to allow more homebuyers to qualify for higher dollar FHA mortgages. If these additional FHA mortgages continue recent historical performance trends and perform the same as past FHA mortgages relative to conventional mortgages, more mortgage delinquencies can also be expected.

Among the announced FHA program changes are higher FHA home mortgage loan limits and lower minimum down payments. The FHA single family loan limit is set at 95 percent of the area's median house price, up to a loan limit. Metropolitan areas will now have limits ranging from $109,032 in low-cost housing areas to $197,621 in high-cost areas--up substantially from the limits previously in effect that ranged from $86,317 to $170,362. Loan limits for special higher-cost markets in Alaska, Guam, Hawaii and the Virgin Islands have been raised to $296,431. Not all areas formerly at the old ceiling were raised to the new ceiling, though, because of the 95 percent rule.

In addition to the new higher loan limits, FHA is moving from a complex mortgage down payment formula to a more simplified one that will enable homebuyers to purchase a home with a lower down payment. The minimum FHA mortgage down payment will now be limited to 3 percent, whereas previously the required down payment could go as high as 7 percent for the highest FHA-insured loans. For those loans well below the old ceiling, though, little change is expected. But the effect on the larger loans in the high price areas is likely to raise the LTV on such loans and thus their risk.

As Table 4 shows, U.S. Government-backed loans, particularly FHA loans, have captured a larger share of the mortgage pool tracked by MIC. FHA mortgages increased their share of the MIC totals, from 2.6% at the end of 1994 to 7.7% in June 1998. This may reflect, in part, the addition of several new firms to the MIC database, who, unlike the GSEs, hold government-backed mortgages. It may also reflect an increased willingness to hold government-backed mortgages.

Table 4: Percent of Total Holdings (MIC, $)

	Dec-94	*Dec-95*	*Dec-96*	*Dec-97*	*Jun-98*
FHA	2.59	3.38	5.44	7.93	7.67
Conventional	95.74	94.25	91.20	87.43	87.95

According to HUD, the cumulative growth in all outstanding FHA mortgages over this period has been substantial. The $409 billion of FHA mortgages outstanding in January 1998 are $72.2 billion greater than the amount outstanding in December 1994 ($336.8 billion) – an average annual growth rate of over 6.7 percent, which matches the overall growth in home mortgages. According to HUD's *Survey of Mortgage Lending Activity*, as a percentage of all mortgages outstanding,

FHA loans have remained at a fairly steady 11 percent of the total over the period.

FHA loans have experienced diametrically different trends relative to conventional mortgages. As seen in Table 5, over the past four and one-half years through June 1998, the delinquency rate on FHA mortgages tracked by MIC has steadily increased while the delinquency rate on conventional mortgages has steadily declined. As a rule, recently underwritten mortgages tend to paid on time. Given the recent growth in the FHA program, one would expect that average delinquency rate to fall with the infusion of newly underwritten loans. But that has not been the case with the FHA mortgages tracked by MIC.

Table 5: Seriously Delinquent Mortgages (MIC, $)

	Dec-94	*Dec-95*	*Dec-96*	*Dec-97*	*Jun-98*
FHA	2.82	2.57	3.30	3.28	3.34
Conventional	0.93	0.77	0.74	0.65	0.58

Moreover, for the MIC participants, the trend in non-government, conventional mortgages has been toward fixed-rate loans because of lower interest rates and a flatter yield curve. But, as shown in Table 6, adjustable rate mortgages (ARMs) have accounted for an increasingly higher portion of FHA mortgages tracked by MIC, rising to 26.6% by June 1998. Adjustable rate mortgages tend to be riskier than fixed-rate mortgages.

Table 6: ARMs as Percentage of Product Type (MIC, $)

	Dec94	*Dec95*	*Dec96*	*Dec97*	*Jun98*
FHA ARMs	13.22	25.12	23.02	27.30	26.57
Conventional ARMs	25.52	18.30	19.56	17.88	16.55

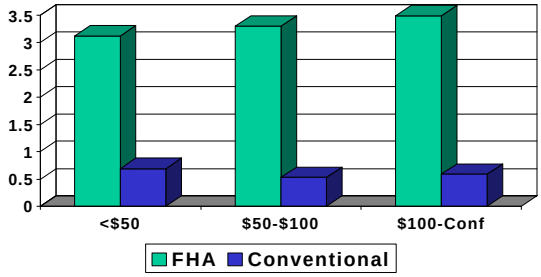
However, even during this period of relatively low interest rates when ARM loans typically perform well, there has been a significant increase in the percentage of delinquent FHA ARMs held by MIC participants. Table 7 illustrates the increasing trend in delinquencies with FHA ARMs, as opposed to a decline in delinquent conventional ARMs. By June 1998, the FHA ARM delinquency rate was four times the rate of delinquent conventional ARMs.

Table 7: Percent Seriously Delinquent (MIC, $)

	Dec94	*Dec95*	*Dec96*	*Dec97*	*Jun98*
FHA ARMs	1.10	2.09	3.37	3.40	4.07
Conventional ARMs	1.53	1.63	1.40	1.13	1.04

Based on the number of loans, the highest percentage of FHA delinquencies held by MIC participants is currently in the group of loans between $100 thousand and the conforming loan limit. With the recently announced availability of larger FHA loans with lower down payments, more delinquencies in larger size FHA loans could evolve, particularly with those ranging in size from over $100 thousand to the conforming loan limit, which already exhibited the highest delinquency rate of 3.49% at June 1998.

Figure 4: Percent seriously delinquent, (MIC,#)



The increasingly high percentage of delinquent FHA mortgages tracked by MIC relate to loans secured by all available property types, but has been most notably for 2-4 dwelling units. As can be seen in Table 8, whereas the delinquency rate on conventional mortgages has been falling dramatically on these types of units, the rate has been rising dramatically for FHA-insured loans on the same type of properties. Consequently, the FHA delinquency rate of 4.9% at June 1998 for loans on these properties is over four times the rate for conventional mortgages.

Table 8: Delinquency Rates by Property Type (MIC,$)

	Dec-94	Dec-95	Dec-96	Dec-97	Jun-98
FHA Mortgages					
SFR	2.82%	2.58%	3.30%	3.37%	3.49%
Condo	2.78%	2.58%	3.09%	3.04%	3.01%
2-4 Dwelling Units	2.28%	2.82%	2.59%	3.96%	4.90%
Conventional Mortgages					
SFR	0.80%	0.68%	0.67%	0.61%	0.56%
Condo	1.49%	1.28%	1.08%	0.78%	0.64%
Co-op	1.42%	1.20%	0.91%	0.54%	0.45%
2-4 Dwelling Units	2.35%	1.98%	1.65%	1.31%	1.14%

With a more aggressive FHA mortgage program now adopted, the need for close attention to the possibility of higher delinquencies in FHA loans is crucial, especially if economic conditions deteriorate. The FHA portfolio appears particularly vulnerable to any significant rise in interest rates due to the likely increased payment pressures on the growing portion of FHA ARMs.

Recent Developments in High LTV Home Mortgage Lending

In a previous issue of *Mortgage Market Trends*, we showed that the loan-to-value ratio is the most important determinant of home mortgage default rates. As the LTV ratio increases, so does credit risk, and rather dramatically at higher LTVs. High LTV (HLTV) home mortgage loans are typically defined as loans secured by liens on or interests in 1-4 family owner-occupied residential real estate that, when combined with any senior liens, exceed 90% of the value of the real estate collateral. Some observers have argued that the recent increase in HLTV lending has been driven by rising homeowner demand for home equity loans to consolidate debt. Table 9 reports HLTV conventional home mortgage originations for S&L's, commercial banks, and mortgage banks from December 1994 to June 1998. As shown in the table, commercial banks have substantially increased the proportion of HLTV mortgages originated, while savings associations and mortgage bankers have decreased their proportion of this kind of lending.

Table 9: Percentage of HLTV Mortgages Originated, (MIRS)

Date	*12/94*	*1295*	*12/96*	*12/97*	*6/98*
S&L's	15	18	17	14	15
Commercial Banks	29	32	30	35	40
Mortgage Companies	33	24	27	27	28

Table 10 reports the percentage of HLTV residential mortgage loans held in portfolio by the market and depositories from December 1994 to June 1998. In sharp contrast to mortgage originations, both the market and depositories show a substantial increase in the number of HLTV mortgages held in their portfolios. This increase in HLTV mortgage lending led OTS to issue *Thrift Bulletin 72* in August of this year to provide guidance to savings associations on high LTV mortgage loans. Some observers and participants in the home mortgage industry have viewed HLTV lending as an innovative improvement in consumer financial technology that doesn't involve substantial increases in risk. Others have expressed concerns about increased risk due to consumers' "reloading" (using credit cards to increase debt after an HLTV debt consolidation loan) and "churning" (using lower debt-to-income ratios resulting from a HLTV debt consolidation to obtain another larger HLTV loan). OTS was particularly concerned that savings associations be aware of the numerous increased risks associated with HLTV lending that differ substantially from traditional home or consumer loans. Included among these increased risks are: (1) increased default risk, (2) inadequate collateral, (3) limited default remedies, (4) excess debt burden incurred by the borrower, (5) untested performance, (6) large loan size, and (7) limited and untested secondary market.

Table 10: Percentage of HLTV Mortgages Held, (MIC $)

Date	*12/94*	*12/95*	*12/96*	*12/97*	*6/98*
Market	7.8	11.9	14.0	17.6	16.9
Depositories	7.3	16.7	18.9	20.0	19.0

Table 11 reports seriously delinquent rates by LTV category. Overall, there is a strong positive relation between the LTV ratio and mortgage delinquency rate.

Table 11: Seriously Delinquent Rates, 6/98, by $ amount, (MIC)

LTV	*20-60*	*61-70*	*71-75*	*76-80*	*81-90*	*91-95*	*96-105*
Market	0.20	0.41	0.57	0.49	0.98	1.30	3.39
Depositories	0.28	0.59	0.77	0.67	1.29	1.68	3.27

These data highlight OTS's concern about the increased credit risk associated with HLTV lending. They challenge one of the conclusions put forth in a July 1998 academic study of HLTV mortgage lending entitled *High Loan-to-Value Mortgage Lending: Problem or Cure?* co-authored by Charles Calomiris and Joseph Mason. In this study, the authors argued that high LTV lending does not increase consumer lending risk. However, our data show that credit risk increases substantially as consumers put themselves into higher LTV categories due to their home mortgage finance decisions.

Tables 12 and 13 show how mortgage delinquency rates for all residential mortgages vary as a function of both LTV and loan size for June 1998. Seriously delinquent rates are reported for both the depositories (Table 12) and the market

Table 12: Depositories – Seriously Delinquent Rates, 6/98, (MIC, $)

LTV	*20-60*	*61-70*	*71-75*	*76-80*	*81-90*	*91-95*	*96-105*
Loan Size							
50	0.33	0.63	0.91	0.91	1.67	2.69	3.97
100	0.26	0.59	0.80	0.79	1.37	1.96	3.30
Conf.	0.24	0.53	0.75	0.74	1.33	1.51	3.14
400	0.27	0.54	0.76	0.53	0.98	1.21	5.41

(Table 13). These results show that the seriously delinquent rate increases as the LTV ratio increases for each loan size. In contrast to FHA loans, there does not appear to be support for the concern that credit risk increases as loan size increases. However, a U-shape characterizes the delinquency rate in the highest

Table 13: Market -- Seriously Delinquent Rates, 6/98, (MIC, $)

LTV	*20-60*	*61-70*	*71-75*	*76-80*	*81-90*	*91-95*	*96-105*
Loan Size							
50	0.25	0.47	0.69	0.72	1.30	2.00	3.92
100	0.18	0.37	0.54	0.53	0.99	1.46	3.33
Conf.	0.17	0.35	0.54	0.47	0.96	1.18	3.37
400	0.23	0.47	0.69	0.47	0.94	1.14	5.36

LTV category for both the market and depositories. That is, the delinquency rate falls as loan size initially increases from $50,000 to $100,000, remains relatively flat from $100,000 to the conforming limit, but then rises as loan size increases beyond the conforming to the $400,000 loan sizes. Generally speaking, the delinquency rates for depositories are higher than those for the market in each LTV category for all loan sizes. The only exceptions are the highest LTV loans where delinquency rates for the market and depositories are virtually the same.

*Mortgage Partnership Finance*Ò Plan

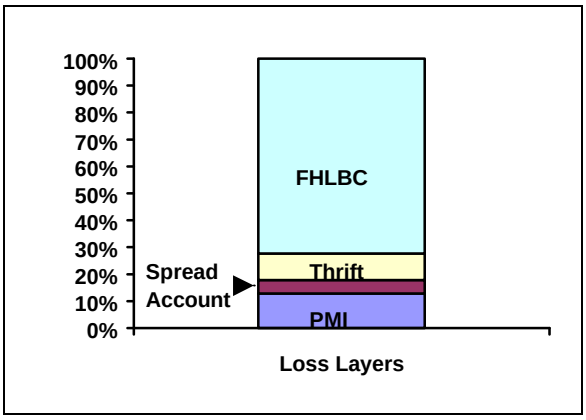
In June 1997, the Federal Home Loan Bank of Chicago (FHLBC) initiated a pilot program that enabled members to divide the component risks of residential mortgages in a novel way. They could now lay off those risks they thought were mostly out of their control and retain those which they thought they could control more closely. This pilot program is under review by the regulatory agencies and its features are subject to change. Nothing stated here should be construed as presenting the official position of the OTS or other banking agencies, but rather the private opinions of the authors of this report.

Funding, credit, interest rate, and prepayment risks are all part of the business of residential mortgage lending. According to the FHLBC, under the *Mortgage Partnership Finance*Ò (MPFÒ) plan, participating thrifts would underwrite conventional home mortgages as an agent for the Federal Home Loan Bank of Chicago. The FHLBC would own the mortgages at closing, provide the funding, and bear the interest and prepayment risks. The participant could service the loans, but the loans would never appear on the participant's balance sheet. However, the participant would provide a credit enhancement, guaranteeing the credit performance of the mortgage, by putting itself in a second-dollar loss position. The FHLBC would pay the participants a monthly fee for the credit enhancement.

Since June 1997, the MPF has grown quickly. Master commitments currently now exceed $805 million. To date, FHLBC has funded over $430 million of mortgages through its participating member institutions. The MPF has recently been adopted as a national program, with a nationwide cap of $9 billion.

Under the MPF's securitization structure (see Figure 5), the private mortgage insurer would be in the first dollar loss position (required if the LTV is greater than 80% at origination), followed by a spread account that would be set up to cover normal and expected losses, then the credit enhancement provided by thrift. The size of the credit enhancement would vary with the quality of the mortgage pool. It would be set equal to the subordination necessary for a security based on the enhanced mortgage pool to achieve a double-A rating. The credit enhancement provided by the thrift is currently expected to be around 4% or 5% of the loan pool, given the quality of mortgages involved and the size of the spread account. The FHLBC bears the residual risk.

Figure 5: MPF's Credit Risk Structure



Only fixed-rate mortgages that have balances at or below the GSEs' conforming limits are eligible for the MPF plan. Excluded are no- or low-documentation loans, very high LTV (greater than 95%) loans, high LTV (80% to 95%) loans without private mortgage insurance, B & C grade mortgages, and second liens. Historically, the excluded mortgage products have had higher credit risk than conventional conforming mortgages.

Capital Requirement Issues

From a thrift's perspective, according to the FHLBC, the advantages of the MPF plan are several. First, it lays off the interest rate and prepayment risks associated with thirty-year fixed-rate mortgages, risks that the thrift may not have a comparative advantage in bearing. Second, the thrift retains its relationship with its customer. Third, it benefits directly by good underwriting, as the thrift receives a fee for providing assurances (the credit enhancement) about the credit quality of the loans it originates. In this way, a thrift can capitalize on what should be its competitive advantage, underwriting home mortgages well. Fourth, and perhaps most controversial, is the current capital treatment of this arrangement. In a microcosm, the issues here are the very ones raised by the Notice of Proposed Rulemaking on risk-based capital standards for recourse and direct credit substitutes (See Federal Register, Vol. 62, No. 214, November 5, 1997, pg. 59944-59976.)

In simple terms, the credit enhancement provided by the thrift could be constructed so that the thrift bears virtually the same credit risk it would have borne had it retained the mortgage pool. The main difference in credit risk between the two positions is the spread account in the MPF plan that is junior to the thrift's credit enhancement. The larger the size of the spread account, the smaller the size of any unexpected losses that would fall on the thrift. But current regulatory capital requirements do not recognize this dependency when dealing with direct credit substitutes.

For ease of exposition, assume the thrift has originated a $1 million pool of home mortgages that qualify for inclusion in the 50% risk bucket. Its capital requirement would be $1m x 50% x 8% = $40,000. Now consider the alternative of conveying the pool under the MPF plan, with the thrift providing a 5% credit enhancement. In other words, by providing the enhancement, the thrift stands ready to absorb up to $50,000 (5% x $1 million) in losses after the spread account is exhausted.

If the credit enhancement is considered as a direct credit substitute, similar to a standby letter of credit issued by a bank, then the capital requirement would be based only on the face value ($50,000) of the credit enhancement, not the amount of the assets enhanced. Banks that issue standby letters of credit currently receive this capital treatment. As a direct credit substitute, the capital requirement is not based on the size of the assets which the credit enhancement supports nor on its subordination position in the risk structure, but just on its face value.

As a credit enhancement, the capital requirement would be the face value of the credit enhancement, $50,000, placed in the appropriate risk bucket, 4% for qualifying mortgages, or $50,000 x 4% = $2,000. So by qualifying as a credit enhance-

ment under current capital regulations, rather than as recourse arrangement, the capital requirement drops from $40,000 to $2,000.

If the transaction were considered a transfer with recourse, however, the capital requirement would be the smaller of capitalizing the recourse exposure ($50,000), or the capital requirement on the grossed-up amount of the credit enhancement (itself and all of the pool that it supports). With a small spread account, the capital requirement would be near the original capital requirement ($40,000). So under one set of capital rules (direct credit substitute), the capital requirement would be $2,000; under another (recourse), almost $40,000, for credit risk positions that could be constructed to be substantially the same.

One of the roles of regulatory capital is to act as a buffer against *unexpected* losses. While this and prior issues of *Mortgage Market Trends* have provided only information on delinquency rates and not actual losses on mortgages, it is quite clear that qualifying fixed-rate mortgages, and especially low-LTV fixed-rate mortgages are very low risk assets, especially during the past five years.

Theoretically, whether a capital requirement of $2,000 is sufficient or $40,000 is excessive to withstand unexpected losses (not reasonably expected losses -- which should already be provisioned for in the spread account) depends both on the frequency and the severity of *unexpected* losses. In the MPF plan, the size of the spread account and whether it is prefunded or accumulates over time will determine in part how often and deeply the credit enhancement provided by the thrift might be tapped. Likewise, the quality of the underwriting and unexpected swings in the local economic conditions will also play a part. For example, with a high quality mortgage pool on properties that rarely experience declines in value and a sufficiently large spread account, the credit enhancement provided by the thrift could be as safe as other types of whole assets and appropriately risk-weighted on its face value.

The regulatory agencies are currently reviewing the capital treatment of the MPF plan, which itself is subject to change.

CONCLUSION

High LTV lending, the expansion of the government insurance program for residential lending, and the financial innovations of the MPF plan can lead to greater borrowing opportunities for would-be homeowners. Like any new opportunity, these innovations can be abused to the detriment of the borrowers, the lenders, or both. An undercapitalized thrift, an over-expanded government program, or an over-extended borrower in default all have implications for our financial system beyond the particular difficulties of the individuals involved. As the number of choices increases, the need for information and thorough understanding also increases so that the appropriate decisions can be made by all partners to a transaction. But used properly, these three mortgage market developments offer exciting possibilities for the future growth of homeownership.

Mortgage Market Trends

Volume 2 Issue 3

December 1998

Data Appendix

National and Regional Trends in Mortgage Delinquency Rates

as of June 30, 1998

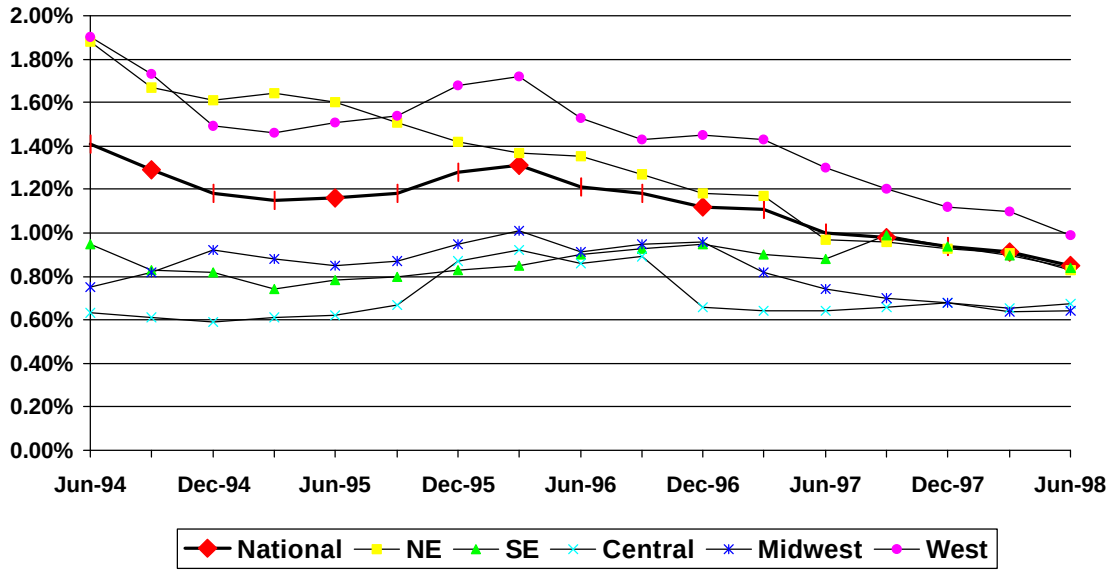
Regional and State Analysis

Seriously Delinquent & Home Price Appreciation Rates as of 6/30/98

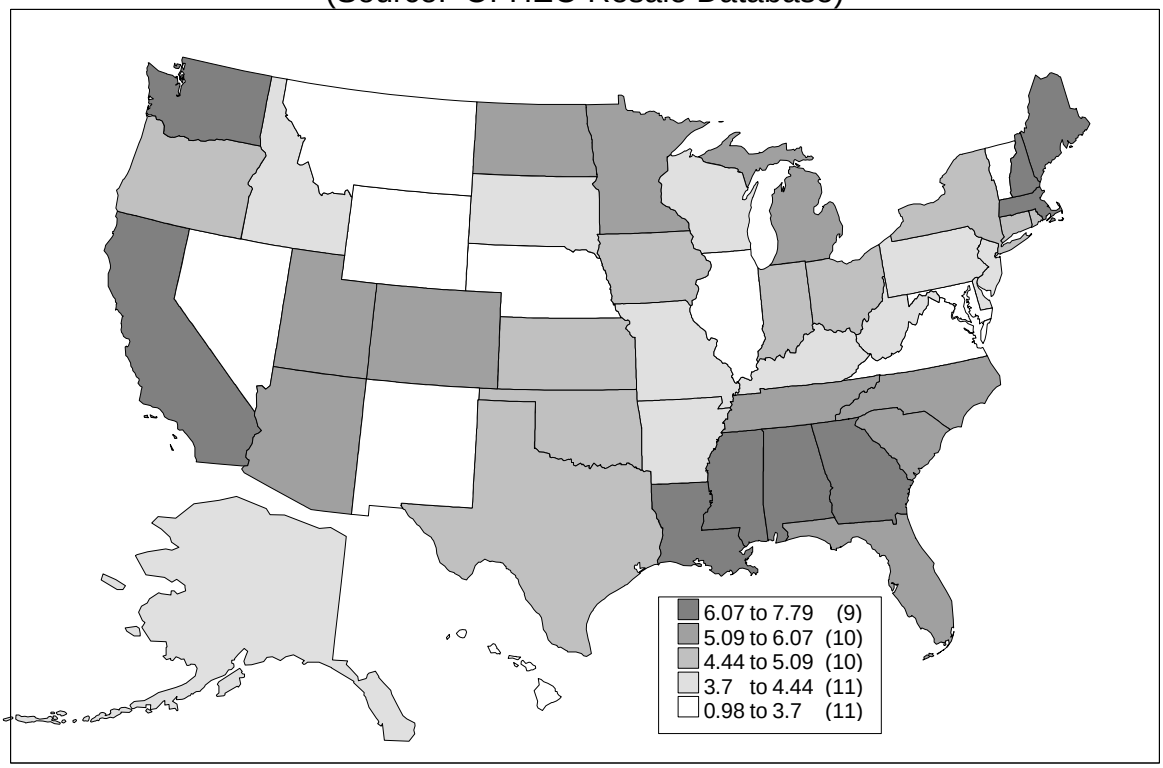
(Based on $)

	MIC SD		TFR SD	Home Price Appreciation	
	Market	Depositories	TFR	1-Year	5-Year
National	**0.90**	**1.22**	**0.85**	**5.2**	**19.2**
Northeast	**1.16**	**1.65**	**0.83**		
Connecticut	1.06	1.40	0.38	4.6	3.5
Delaware	0.84	1.30	0.53	4.1	6.4
Maine	0.76	1.36	1.03	6.1	10.5
Massachusetts	0.58	0.74	0.51	6.2	18.0
New Hampshire	0.47	0.70	0.46	6.7	12.9
New Jersey	1.50	2.24	1.26	4.3	8.2
New York	1.49	1.87	0.81	5.1	6.5
Pennsylvania	1.07	1.69	0.82	4.3	9.8
Rhode Island	0.77	1.01	2.15	4.9	3.8
Vermont	0.50	1.02	1.52	1.7	5.6
West Virginia	0.31	1.01	0.73	3.7	26.3
Southeast	**1.08**	**1.42**	**0.84**		
Alabama	0.62	1.39	1.16	6.6	25.6
DC	1.49	1.70	2.26	3.6	3.1
Florida	1.22	1.40	0.59	5.6	16.5
Georgia	0.81	1.26	0.77	6.5	24.8
Maryland	1.68	2.26	1.87	3.5	6.8
North Carolina	0.75	0.98	0.46	5.2	27.4
Puerto Rico	0.92	2.79	6.73	*	*
South Carolina	0.90	1.10	0.44	6.1	24.3
Virginia	0.86	1.12	0.69	3.3	9.6
Central	**0.59**	**1.22**	**0.67**		
Illinois	0.84	1.33	0.80	3.2	20.7
Indiana	0.62	1.34	0.97	4.6	27.8
Kentucky	0.39	0.90	0.82	4.4	28.4
Michigan	0.22	0.47	0.71	5.9	39.9
Ohio	0.56	1.22	0.58	4.6	27.7
Tennessee	1.11	1.97	0.49	5.3	30.7
Wisconsin	0.27	0.69	0.26	4.1	33.6
Midwest	**0.58**	**0.94**	**0.64**		
Arkansas	0.98	1.60	0.56	4.1	24.1
Colorado	0.35	0.50	0.23	5.7	45.7
Iowa	0.22	0.26	0.87	4.9	30.5
Kansas	0.47	0.73	0.28	4.5	30.5
Louisiana	0.96	1.83	0.34	6.2	30.5
Minnesota	0.37	0.55	0.32	5.2	28.1
Mississippi	0.80	2.32	0.90	6.8	27.2
Missouri	0.43	0.66	0.38	4.1	24.8
Nebraska	0.23	0.34	0.69	3.6	31.8
New Mexico	0.68	1.03	0.92	2.7	29.4
North Dakota	0.41	0.43	0.29	5.6	25.4
Oklahoma	0.74	1.23	0.46	4.9	22.6
South Dakota	0.49	0.80	0.73	4.4	30.2
Texas	0.78	1.18	0.91	4.7	15.3
West	**0.92**	**1.03**	**0.99**		
Alaska	0.49	1.33	0.00	4.3	21.4
Arizona	0.55	0.74	0.40	4.1	29.2
California	1.04	1.12	1.06	7.8	3.0
Hawaii	1.57	2.26	1.72	1.0	-10.4
Idaho	0.64	0.70	0.16	4.4	29.8
Montana	0.62	1.19	0.51	3.3	35.8
Nevada	1.12	1.35	-	3.5	15.6
Oregon	0.32	0.33	0.39	5.1	48.7
Utah	0.60	0.87	0.81	5.8	64.6
Washington	0.56	0.57	0.28	6.8	25.3
Wyoming	0.41	0.56	0.38	2.2	34.5

OTS Regions
Seriously Delinquent Mortgages (%)
Based on Thrift TFR Data by Location of Headquarters

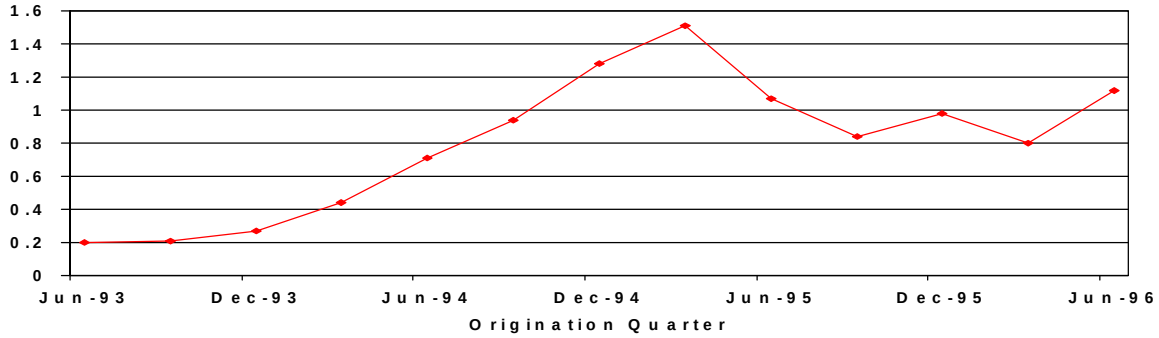


Percent Home Price Appreciation
1997Q2 to 1998Q2
(Source: OFHEO Resale Database)



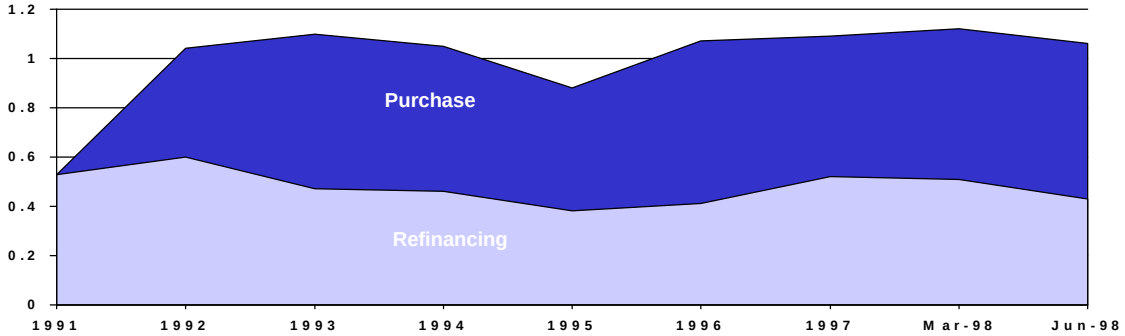
National Cohort Performance by Quarter of Origination

Percent Seriously Delinquent after 24 Months
(Source: MIC)



Home Purchase Vs. Refinancing Mortgages

(Source: MIC, Percent Seriously Delinquent)



Fixed Vs. Variable Rate Mortgages

(Source: MIC, Percent Seriously Delinquent)